

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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In the Matter of the Joint Application of)	
NorthWestern Corporation and Babcock & Brown)	UTILITY DIVISION
Infrastructure Limited, BBI US Holdings Pty Ltd.,)	
BBI US Holdings II Corp., and BBI Glacier Corp.)	DOCKET No. D2006.6.82
For Approval of the Sale and Transfer of)	
NorthWestern Corporation Pursuant to a Merger)	
Agreement)	

**POST-HEARING BRIEF OF
MONTANA CONSUMER COUNSEL**

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The Montana Consumer Counsel (“MCC”) submits this post-hearing brief in accordance with the procedural schedule established at the conclusion of hearings in this matter on March 16, 2007 (Mar. 16 Tr. at 257-258), as modified by Notice of Staff Action issued April 10, 2007. As demonstrated at the hearing, and as explained in detail in this brief, the acquisition of NorthWestern Corporation (“NorthWestern”) by Babcock & Brown Infrastructure Limited (“BBIL”) (collectively, the “Applicants”) as proposed would undermine the ability of NorthWestern to provide adequate utility service at rates that are reasonable and just following the acquisition. Adoption of each of the seven conditions proposed by the MCC, and discussed in this brief, is required to mitigate the threat posed to adequacy of utility service and facilities, and to the reasonableness and justness of NorthWestern’s post-acquisition rates, by the acquisition as proposed by the Applicants.

I. OVERVIEW

The principal threat that the acquisition poses to NorthWestern's ability to fulfill its public service obligations under Montana law results from BBIL's demonstrated intention (with respect to NorthWestern) (Exhibit MCC-3 at 20-38, Exhibits JW-1 through JW-5; Mar. 15 Tr. at 143-171 (Wilson)), and its established practice (with respect to its existing operating subsidiaries) (Exh. MCC-3 (Exh. JW-7); Exh. MCC-8; Mar. 16 Tr. at 18-24 (Boulton)) of consistently paying out dividends in excess of net earnings. BBIL's dividending practices are projected -- by the *pro forma* financial model that BBIL used to justify the acquisition to its Board and to the rating service for the debt with which BBIL proposes to finance this acquisition -- to drain the equity out of NorthWestern's capital structure. This equity drain, in turn, will leave NorthWestern's ability to fulfill its public utility service obligations dependent on decisions made by a foreign holding company board and the future financial condition of that holding company, both of which will be beyond the Commission's reach as to advances of the funding needed to fulfill NorthWestern's public service obligations. The equity drain resulting from BBIL's practice of distributing one hundred percent of "free cash flow" is likely to increase the cost of electric and gas utility service to customers, to limit and impair the ability of NorthWestern to manage perturbations in its financial situation (including recognitions of asset impairments, sudden input cost increases and other unforeseen developments) and concomitantly to increase the risk to utility customers of inadequate and higher cost utility service. Accordingly, the Commission cannot permit the acquisition to proceed as proposed by the Applicants.

The Commission could permit the acquisition to proceed only by imposing conditions that ensure the preservation and protection of NorthWestern's ability to provide adequate

service at rates that are reasonable and just (MCA § 69-3-201), pursuant to its “full power of supervision, regulation, and control of . . . public utilities” (MCA § 69-3-102). MCC recommends that, at a minimum, the Commission should impose the following conditions on the proposed acquisition:

1. There should be no recovery in retail rates, directly or indirectly, in any manner or by any means, of any portion of any premium over book value paid or proposed to be paid for the acquisition of control of the Montana public utility assets currently owned by NorthWestern, unless such recovery is expressly and affirmatively authorized by order of the Commission upon application demonstrating specific and concrete benefits to Montana consumers resulting from the payment of such premium. The exclusion established by this condition shall apply equally to (a) the approximately \$700 million premium over book value proposed to be paid by BBIL to acquire NorthWestern, (b) the \$375 million premium over book value previously paid by NorthWestern to acquire the assets of Montana Power Company, and (c) the \$60 million “reorganization intangible” booked by NorthWestern upon its emergence from Chapter 11 protection in November 2004. The exclusion established by this condition shall apply equally to treating any of the premiums over book value described in the preceding sentence as (i) part of rate base, (ii) part of operating expense and (iii) part of NorthWestern’s equity capitalization for purposes of determining retail rates.
2. The transaction and transition costs incurred by BBI and NorthWestern shall be absorbed exclusively by the shareholders of each of the parties to the

acquisition. None of the \$88 million in “facilitation fees” and transaction costs associated with this transaction shall be treated as “deferred financing costs” for purposes of retail rate recovery or as part of NorthWestern’s equity capitalization for purposes of determining retail rates.

3. Unless specifically and affirmatively authorized by the Commission, there should be no distribution, directly or indirectly, from NorthWestern to its owners, affiliates or to stockholders of affiliates, of any amount exceeding 100 percent of NorthWestern’s net earnings in any year.
4. The merged company may only use financing that is neither secured by NorthWestern’s utility assets nor guaranteed in any manner by its retail utility revenues (*i.e.*, financing that is non-recourse to NorthWestern and its customers) for the development of any capital project having a principal purpose other than the provision of adequate service to retail public utility consumers.
5. The existing structural and financial measures, intercorporate and affiliate transactions requirements, reporting and disclosure requirements, and infrastructure audit compliance requirements from Order No. 6505e (the Financial Investigation Consent Order), should be maintained in place, subject to modification of the following provisions:
 - a. Changes to the definition of the term “Parent Company” are required throughout Ordering Paragraph C.1 (structural measures) and C.2 (financial measures) in order to ensure that, after consummation of the

acquisition, NorthWestern remains the entity vested with title to and control over the public utility assets used to serve Montana consumers;

b. Ordering Paragraph C.3.a should be modified to reflect a basis for determining consolidated book equity and consolidated total capitalization that is meaningful as a regulatory tool in the context of the post-acquisition corporate structure, and the financial reporting requirements to which that corporate structure will be subject. Specifically, dividends should be limited to no more than 75 percent of net earnings at any time when equity (defined as assets less all goodwill, less unamortized acquisition expenses less all liabilities) is less than 40 percent of the sum of equity and all debt, and to no more than 90 percent of net earnings at any time when equity is between 40 percent and 45 percent of the sum of equity and all debt, using all values as reported in the utility's audited FERC Form No. 1 Annual Report.

6. NorthWestern shall submit rate informational filings every three years, commencing on the first anniversary of consummation of its proposed acquisition by BBIL, conforming to the requirements of Ordering Paragraph B.1 of Order 6505e (including responding to discovery) for rate review for the initial ten years following the acquisition, to ensure against excessive rates.
7. NorthWestern and BBIL shall provide contemporaneous notice and availability to the Commission of financial disclosure documents filed by NorthWestern's parent/affiliate BBIL in the Australian Stock Exchange or the Australian Securities and Investments Commission.

Only the imposition of all seven conditions proposed by the MCC -- including specifically those resisted by the Applicants in their testimony (Exh. JA-4 at 8-9; Exh. JA-6; Exh. JA-7 at 6-8, 12, 13-16) and opening brief -- will be sufficient to protect the ability of NorthWestern, post-acquisition, to fulfill its public utility service obligations under MCA § 69-3-201: to “furnish reasonably adequate service and facilities” and “the charge made by any public utility for . . . for any service to be rendered as or in connection with any public utility shall be reasonable and just.” Any conditions less comprehensive or less certain in their application than those stated above and explained herein will fail to prevent the deterioration of NorthWestern’s capital structure and its ability to provide adequate service and facilities at reasonable and just rates.

II. THE COMMISSION’S CONDITIONING AUTHORITY

The Commission has ample authority to condition approval of the proposed acquisition, and to deny outright authorization to proceed with it, notwithstanding the Applicants’ assertions to the contrary (App. Op. Br. at 5-8). The Commission’s authority to ensure a utility’s compliance with its public service obligations in the context of a transfer of control like the one at issue in this case has been recognized in Montana since at least 1927. *Gallatin Natural Gas Co. v. Public Service Comm’n*, 79 Mont. 269, 289-290, 256 P. 373, 378-379 (1927). The Commission correctly predicates its authority to regulate mergers and acquisitions of and by Montana public utilities both on its duty to enforce the public service obligations of utilities under MCA § 69-3-201, and on its “full power of supervision, regulation, and control of such public utilities” (MCA § 69-3-102). *In the Matter of the Application of WorldCom, Inc. and MCI Communications Corp.*, D97.10.191; Order No. 6043b at ¶ 10 (1998). Indeed, the Applicants’ misplaced reliance on the discussion of the

Legislature's refusal to adopt territorial exclusivity for public utilities in *Great Northern Utilities Co. v. Public Service Comm'n*, 88 Mont. 180, 218, 293 P. 294, 303 (1930) (App. Op. Br. at 6) caused them to overlook the portion of that case that is precisely relevant to the proposed transaction presently before the Commission (*id.* at 218-219):

The reasonable service which the statute requires the Utility to furnish, and which it is made the duty of the Commission to see is furnished, must be paid for out of the revenues derived from the sale of the product of the Utility. . . . It is an inexorable law that if more is taken out than is put in, regardless of how large the surplus, the supply will eventually be exhausted. . . [and] then the provisions of the statute are rendered impotent, for the Commission is unable to regulate the character of service to be rendered.

The need to avoid a situation in which “the provisions of the statute are rendered impotent, for the Commission is unable to regulate the character of service to be rendered” is the premise of each of the conditions recommended by the MCC, and furnishes the Commission with all of the authority that it needs to impose conditions on any approval it might otherwise be persuaded to give the proposed acquisition. Applicants' arguments to the contrary are insubstantial.^{1/}

^{1/} The Applicants also rely on a statement from a 1948 Commission decision in *In re Eastside Telephone Co.*, 77 P.U.R. (N.S.) 87 (1948) to the effect that “the Commission does not have authority over transfers or sales of utilities.” Whatever that statement may have been intended to convey when made, it is so clearly out of step with authoritative judicial interpretations of the scope of the Commission's authority (discussed above), and numerous, more contemporary, determinations by the Commission of the scope of its authority over sales and transfers of utilities and utility assets as to require no further harmonization.

**III. THE PROPOSED ACQUISITION WOULD ADVERSELY
AFFECT NORTHWESTERN'S ABILITY TO PROVIDE
ADEQUATE FACILITIES AND SERVICE AT RATES
THAT ARE REASONABLE AND JUST**

**A. The Proposed BBIL Acquisition Would Impair
NorthWestern's Ability to Fulfill Its Public Service Obligations**

Following its emergence from bankruptcy in November 2003, NorthWestern has improved its financial posture by reducing debt and increasing retained earnings. In contrast to a 25.67 percent equity ratio (excluding "goodwill") at December 31, 2004, NorthWestern had increased the equity component of its capital structure to 31.41 percent by December 31, 2006 (Exh. MCC-1 and MCC-5; Mar. 14 Tr. at 54, lines 7-17 (Hanson)). As a result, NorthWestern's secured debt rating was raised from "junk" status to the lowest investment grade level. The Company's unsecured debt generally remains below investment grade (Mar. 14 Tr. at 103:3-12 (Hanson)). Looking forward, according to NorthWestern's January 2006 Long Range Management Forecast, NorthWestern has forecasted that by 2010 it would achieve an equity ratio of 41 percent (excluding new debt to buy out the Colstrip 4 lease obligation) by further reducing debt and increasing retained earnings (Exhibit MCC-6 [Confidential] at 13-14). If that forecast is achieved, it is reasonable to anticipate the attainment of a solid BBB debt rating by Standard & Poor's. In contrast, BBIL's own current and projected post acquisition debt rating remains at the lowest investment grade level. (Mar. 14 Tr. at 180:18-23 (Garland)).

Although BBIL and NorthWestern have claimed that the BBIL acquisition will enhance NorthWestern's access to capital markets, there is no evidence that capital access and costs would improve compared to those which NorthWestern could achieve on its own. Certainly, comparative bond ratings do not suggest that result. Instead, the compelling

evidence in this case is that BBIL's ultimate purpose is to extract large amounts of capital from NorthWestern to pay off its acquisition premium^{2/} and to make future capital infusions available only when it is persuaded that the resulting returns will be more attractive than capital expenditure opportunities available in its other spheres of operation (assuming that BBIL has funds available or can obtain them from debt or equity markets).^{3/}

^{2/} It is clear that BBI intends to recover its acquisition premium (in excess of \$700 million) from NorthWestern and that NorthWestern's only source of cash flow to provide this recovery is revenues from its customers. As stated by BBI witness Garland (Mar. 15 Tr. at 40:6-10):

- Q. Describe the mechanism that BBI intends to recover the acquisition premium value.
- A. Purely by the dividends paid by NorthWestern to Holdings II and under its normal operational business."

That BBI intends to recover its \$700 million acquisition premium is also evident from the results of its acquisition model which shows the projected realization of a 13.6 percent return on BBI's total equity cost of the acquisition, including the \$700 million premium. (Mar. 16 Tr. at 175-176 (Sellar)).

^{3/} When asked directly how the utility would really benefit from the takeover, NorthWestern witness Hanson was hard pressed to offer anything more concrete than speculation that a change in ownership would free management from the distraction of "vulture capitalists" who owned the company's stock when it emerged from bankruptcy -- previous stockholders who have since sold or substantially reduced their interests (Mar. 14 Tr. at 114:9-25):

- Q. Will NorthWestern still be able to make these investments if this transaction does not close?
- A. I believe we could make those investments, yes.
- Q. How will this transaction that's before us specifically allow NorthWestern to pursue infrastructure development that it couldn't pursue otherwise?
- A. Again, I can't give a quantified dollar and cents benefit. I think the benefit I was trying to describe in my testimony is it will bring stability to the ownership of the company, allowing us to avoid distraction and a resource drain that we've had to deal with over the last couple of years, protracted litigation, various advisors, very expensive things that we could put together to better use, focus specifically on utility investments and utility service.

Nor was Mr. Hanson able to identify any operational problems for NorthWestern resulting from a potential future migration of "short-term" investors to other market opportunities more

Strengthening NorthWestern's equity ratio and debt rating remain critically important to NorthWestern's meeting future capital investment needs -- both for growing service requirements and for the replacement and maintenance of existing equipment and facilities. Healthier equity ratios and debt ratings both expand capital availability and reduce capital costs.

In contrast to NorthWestern's recent financial achievements, the evidence in this case clearly shows that, as a consequence of BBIL's planned takeover, NorthWestern's trends in earnings retention and improvements in equity capitalization will be reversed. As the MCC demonstrates in the pages immediately following, BBIL plans to pay out well over 100 percent of total earnings in each year, resulting in negative retained earnings and severe equity impairment. Referring to the BBIL Acquisition Model, which shows all of NorthWestern's available cash flow being paid out in dividends (averaging about 150 percent of total net income over the next 17 years), BBIL witness Boulton stated: "In terms of available cash flows we'll be looking at the model. That's the -- we've been quite open. That's the methodology that we apply to all of our businesses..." (Mar. 16 Tr. at 155:7-10).^{4/}

suitied to their profit aspirations. (March 15 Tr. at 216:4-226:12 (Hanson) and Response to Data Request MCC-134).

^{4/} BBI applies this same dividend payout model to its other businesses. Powerco, BBI's New Zealand electric utility has been required to pay BBI dividends exceeding earnings in each year since its 2003 acquisition. Powerco's equity, which was NZ\$596.8 million at April 1, 2004 was, as a result of dividend payments in excess of earnings, reduced to NZ\$562.0 million at April 1, 2005 and again to NZ\$533.1 million at April 1, 2006. (Mar. 16 Tr. at 20-21 (Boulton); Exh. MCC-8 at 11):

Q. Now, that is not the way in which NorthWestern has distributed to its shareholders historically; is that correct? In other words, this represents the Powerco financials that we just looked at. MCC-8 represents distribution to -- in the form of dividends in excess of net profits correct, for both years?

A. Those figures to the profit, that's right.

While the severity of the financial impairment resulting from this negative earnings retention policy varies depending on whether new projected interstate transmission investments are included or excluded from the financial analysis, the projected end result is a major deterioration in NorthWestern's capital structure in either case.

During the hearing on this matter BBI sometimes appeared to argue that a proper evaluation of its financial plans should be done on a consolidated basis, including the new transmission investments (i.e., that, they said, was their "acquisition model" as opposed to the alternative "Wilson model" with the new interstate transmission projects removed).^{5/} At other times they appeared to argue that inclusion of the new transmission projects in the

Q. And NorthWestern has certainly since its emergency [sic] from bankruptcy dividended less than its net profits; is that right?

A. Since bankruptcy, that would be right.

The evidence in this case shows that BBI's dividend payout plan for NorthWestern contemplates a similar, but larger, equity reduction despite NorthWestern's already very thin equity ratio.

^{5/} In addition to its base acquisition model, BBI also prepared and presented several additional model runs (which they referred to as "sensitivity tests") for its Board in April 2006 for consideration in evaluating the proposed takeover of NorthWestern. One of these was a run identical to the basic acquisition model, but eliminating the potential new investment in two large FERC-regulated transmission projects - - the contemplated Idaho line and the Colstrip transmission upgrade. During discovery in this case, MCC requested and BBI provided this additional "without transmission" model run. Dr. Wilson referred to this model run and reported certain results from it (in addition to corresponding results from the base acquisition model) to show that, either way - - either with the new transmission investments or without them, the implementation and end result of BBI's financial plan for NorthWestern was the same: annual dividend payouts would greatly exceed earnings, and equity capital would be drained down to unacceptably low levels. Although the "without transmission" model run was produced solely by BBI for its Board's consideration in April 2006, BBI witness Sellar appeared to attempt to disassociate its results from BBI and dubbed it "the Wilson model" in his data request responses. In any event, the whole point of presenting both model results (the base acquisition model as well as the same model without the new transmission projects) was to show that BBI's equity pay-out intentions were the same under any contemplated operating circumstances.

analysis was inappropriate because they were not Montana jurisdictional regulated investments. ^{6/}

Fortunately, the MCC's analysis examined BBIL's payout forecasts both ways -- both including the new transmission projects (the "Acquisition Model") and adjusted to exclude these projects (the "Wilson model"). In both cases, BBIL's forecasted dividend payments average well over 100 percent of total equity earnings over the next 17 years, and in both cases the resulting equity percentage is drained down to dangerously low and unacceptable levels over time - - to 16.9 percent including the transmission projects (Exh. MCC-3 at 24) and to only 4 percent without these projects (Exh. MCC-3 at 34).

B. Dissipation of Equity Capitalization Is Likely to Imperil Service and Rates

Draining NorthWestern's real equity capital by paying out more than 100 percent of earnings, as BBIL's forecasts (and the financial management of its other operating companies portend), would impair NorthWestern's ability to provide adequate service and facilities at rates that are reasonable and just (MCA § 69-3-201) because equity capital is the

^{6/} Contrast Mr. Sellar's rebuttal testimony, Exhibit JA-7 at 10 with his criticism of the results of the "Wilson model" because new transmission investments were removed. Mr. Sellar subsequently acknowledged that the so-called "Wilson model" was, in fact, a "sensitivity" run that BBI had done for its own Board's review in April, 2006 (Mar. 16 Tr. at 185-188 (Sellar)):

Q. So how, if at all, did that run differ from the run that was provided to Dr. Wilson in discovery, the sensitivity without the transmission?

A. Without checking I would imagine it wouldn't be significantly different. There may have been individual inputs that may have changed. Because the Board - - the date of the Board's presentation was not the date that the bid was lodged with NorthWestern.

So there may have been some input changes up until the date of the finalization of the bid. So without checking the model in detail -- I confirm they are exactly the same -- I would expect that they would not be significantly different.

financial reserve on which any business depends to weather, unforeseen events or business fluctuations. Such fluctuations occur even in regulated gas and electric utility businesses when sales variations occur (e.g., as a result of unexpected weather, economic changes or other causes) or when costs change unexpectedly between rate cases (e.g., as a result of unexpected cost spikes, storm damage or other abnormalities) or if assets are revalued, as may occur for NorthWestern in conjunction with annual reviews of potential goodwill impairment. If revenues decline, costs increase or assets are revalued unexpectedly, and financial reserves (i.e., equity capital balances) are inadequate to cover contingencies, insolvency (i.e., bankruptcy) is the result. For these reasons, utilities typically strive to maintain equity ratios in the 40 to 50 percent range and dividend payout ratios in the range of 70 percent of earnings. BBIL's financial forecasts contemplate payouts at double this level with resulting equity ratios far below those needed to sustain reasonable credit.

The recognition of impairment of the value of its assets was the proximate cause of NorthWestern's decision to seek bankruptcy protection in September 2003, following its recognition at the end of 2002 of approximately \$878.5 million in impairments and related reductions in the value of its non-utility holdings. If the currently proposed acquisition were to proceed, NorthWestern would again have substantial segments of its asset values subject to revaluation subsequent to consummation of the acquisition. Looming large among these would be approximately \$1 billion of "goodwill," acquisition adjustments arising both out of the BBIL acquisition and out of the acquisition of Montana Power Company by NorthWestern, and deferred transaction cost recovery. While BBIL has stated repeatedly that it will not attempt to recover these costs from ratepayers, BBIL's acquisition model clearly projects that its cash payout plan will produce a 13.6 percent rate of return on BBIL's total

equity investment, including its approximately \$700 million acquisition premium in this takeover plus the \$435 million of goodwill carried forward from NorthWestern's previous acquisition of Montana Power and bankruptcy emergence. (Mar. 16 Tr. at 175:19 - 176:6 (Sellar)). The sole source of this cash payout is, of course, revenues obtained from the Company's customers. Notwithstanding assurances that no recovery of acquisition premiums will be sought from ratepayers, the record in this case demonstrates that BBIL fully expects that rate revenues embodying rate of return allowances reflecting far more equity capital than remains on NorthWestern's books (net of goodwill) will, in fact, recover that premium. If, as it should, sound regulation prevents these excessive returns from occurring and, therefore, the recovery of acquisition premiums and related acquisition costs from ratepayers becomes impossible, a substantial revaluation of goodwill asset value (and therefore of book equity value) is a distinct possibility.

BBIL attempted to deflect the significance of its own forecasts by arguing (JA-7 at 12:21-23) that MCC witness Dr. Wilson had used a "poorly selected" sample of companies to support his observation that dividend payouts in the 70 percent range are typical in the electric and gas utility industries, as contrasted with BBIL's projected distributions in the 140 to 150 percent of earnings range. BBIL witness Sellar asserted that a properly selected sample of comparable utility companies shows that much higher payouts of all or nearly all earnings are the appropriate norm that should be considered in evaluating BBI's dividend payout plans for NorthWestern (*id.* at 13:1-24). Cross examination of Mr. Sellar, however, demonstrated that the average payout, even for his selected companies, was really 73 percent (Mar. 16 Tr. at 180-185). He had obtained and reported a much higher (and misleading)

payout “average” by using a distorted computational procedure.^{7/} Notwithstanding the collapse of its attempt at statistical legerdemain, BBI continues to argue in its brief that its dividend payout plans for NorthWestern are appropriate (App. Op. Br. at 24).^{8/}

^{7/} As illustrated in Exh. MCC-12 and MCC-13, Mr. Sellar computed average payouts by averaging individual annual payout ratios instead of relating total earnings to total dividends. Thus, a company that pays dividends of 50¢ in each of five years and earns \$1.00 in four years but only 5¢ in one year (earnings total \$4.05 and dividends total \$2.50) is represented by Mr. Sellar as having an average payout of 240 percent $[(50 \text{ percent} + 50 \text{ percent} + 50 \text{ percent} + 50 \text{ percent} + 1,000 \text{ percent}) / 5 = 240 \text{ percent}]$ instead of 62 percent $(2.50 / 4.05 = .617)$ (Mar. 16 Tr. at 180-185).

^{8/} In addition to reasserting Mr. Sellar’s discredited contention that the 70 percent payout norm reported by MCC is attributable to selecting an unrepresentative sample of comparable utilities, BBIL argues that there is no nexus between restricting payouts and maintaining equity, financial health and adequate service and that “neither NorthWestern nor BBI is aware of any U.S. corporation, utility or otherwise, where [restricting dividends to a percentage of earnings] is imposed or has even been evaluated over time” (App. Op. Br. at 24). As to the first of these arguments, there can be no real dispute. There has simply never been a utility anywhere in the United States that has regularly paid or planned to pay dividends exceeding 100 percent of earnings over an extended period of years as BBIL’s forecasts demonstrate that it plans for NorthWestern. Dividend payouts are reported each year in utility annual reports, which are summarized for the last fifteen years in *Value Line*, to which the Commission subscribes. The veracity of BBI’s and MCC’s conflicting claims on this matter can be easily checked from this well-known public information.

BBI witness Garland also mistakenly argued that “there’s lots of [utilities with distributions higher than net earnings] in the United States if you look around. Even close to Montana there is Avista. You go back east to Central Vermont, there are lots of them” (Mar. 15 Tr. at 23:15-19). Mr. Garland evidently relied on Mr. Sellar’s Exhibit 1, which purported to show Avista with a 90 percent payout and Central Vermont with a 142 percent payout (Exh. JA-7 (Sellar Rebuttal) at Exhibit 1), and appears to have been confused by Mr. Sellar’s misleading calculation procedure used in that exhibit -- *i.e.*, Mr. Sellar reported payout ratios of 207 percent for Avista and 475 percent for Central Vermont in 2001 (*id.*). In fact, over the ten-year period considered (1996-2005), Avista and Central Vermont had equity payout ratios of 73.3 percent and 81.8 percent, respectively, in comparison with the 73.8 percent average for Mr. Sellar’s entire group. [See Exh. MCC-13, Exhibit 1 (Revised)].

As to the nexus between payout ratios, maintaining equity, financial health and adequate service, the answer is nearly as venerable and longstanding as public utility regulation itself. It is this: excessive payout ratios drain equity; inadequate equity means no safety net against business fluctuations and asset revaluations, and only limited high cost access to capital markets; impaired safety, limited capital access and reduced business flexibility, in turn, threaten the adequacy and raise the cost of utility service.

Utilities also pay out less than their entire available cash flow because plant and equipment replacement (typically at more than historic cost) is an essential part of maintaining adequate service. As Dr. Wilson showed in Exhibit JW-4 of MCC-3, BBIL's financial model for Northwestern contemplates far less ongoing plant investment than is typical for U. S. electric utilities. As was observed at the hearing by Commissioner Mood (Mar. 15 Tr. at 145:22 – 146:17):

Q. ...phantom taxes, I think, broadly can be defined as the government's recognition that the equity in a company needs to be replaced, the plant equipment needs to be replaced, and they are allowing certain tax breaks to occur because in anticipation of replacement.

A. I agree with you.

Q. So both in the case of the free cash flow where depreciation is being moved up to the parent company and in the case of ... phantom taxes, what's happening is that the ability of the company to replace needed equipment is being compromised by the flow of money out of the company.

A. I agree with you. And as I've shown in my exhibits, JW-4 in particular, the capital expenditures that are contemplated by this company are way below the norm in the electric utility industry in terms of capital expenditures per customer, in terms of replacement of wearout, what have you.

While BBIL asserts that it expects to be capable of infusing new capital into the utility when it is needed and justified, that is far less comforting than a financially solvent and adequately ring-fenced utility with sufficient retained earnings (i.e., equity) in its capital structure to secure its own financing capabilities.

C. Intangibles in Equity Capitalization and the Acquisition Premium Problem

The Applicants attempt to cloud the payout/equity capital picture by stating Northwestern's equity ratio on a GAAP (as opposed to regulatory) accounting basis - - a

basis under which all “goodwill” is included in the utility’s common equity.^{9/} This includes not only \$435 million of currently existing “goodwill” stemming from the acquisition premium that NorthWestern paid to Montana Power (TouchAmerica) and an additional premium at bankruptcy emergence, but also the \$700+ million acquisition premium that BBI expects to pay for NorthWestern. While BBI says that it does not intend to recover this acquisition premium from ratepayers, that is exactly what happens when non-goodwill equity (“real equity”) is stripped out through excessive dividend payments while rates continue to reflect a normal utility capital structure -- either through the explicit inclusion of goodwill (as in the BBI acquisition model) or through the use of a “hypothetical” capital structure for ratemaking as was suggested by Mr. Hanson (Mar. 15 Tr. at 233:13-18):

And so it is my view and my understanding that the equity ratio of the corporation as a whole does not necessarily have any bearing on the equity ratio determined by the Commission for purposes of setting rates as to what the proper capitalization used to finance the rate base was.

Subsequently, Mr. Hanson offered to accept, as a condition, that the existing \$435 million of goodwill would not be included in the Company’s equity capital for ratemaking purposes (Mar. 15 Tr. at 234:6-235:5):

- Q. Now, the question is, would you include that \$435 million as equity in determining NorthWestern’s weighted average cost of capital? ...
- A. Since our intent and approach would not be to include the goodwill in the rate base, using the same formula it would not be included in equity. I guess my testimony is, my

^{9/} See March 14 Tr. at 54:11-17, where Mr. Hanson acknowledges that NorthWestern’s current equity ratio declines to the “low 30s” (rather than the 50/50 ratio that he reports) if the present \$435 million of goodwill (the \$375 million acquisition premium from the Montana Power purchase and the \$60 million “reorganization intangible”) is removed from the common equity component.

understanding of the approach is the equity amount is a derived number.

Q. Okay. So you are saying you could not include the amount in determining your weighted average cost of capital.

A. That is correct.

Q. Okay. Let me just ask one more question on that before we go. Are you willing to accept that as a condition of approval of your merger, your acquisition?

A. Mr. Coyle, both NorthWestern and BBI have indicated that willingness.

This condition and its strict enforcement should, of course, be required by the Commission. However, Mr. Hanson's acceptance of this capital structure condition at the hearing is entirely inconsistent with the capitalization test condition now proposed by the Applicants (App. Op. Br. at 29 & n. 4), which (both by negative implication, based on the lack of an explicit proposal to exclude pre-acquisition goodwill on NorthWestern's book from the proposed "capitalization test" and by explicit inclusion in capitalization pursuant to the last sentence of the first paragraph of footnote 4) attempts to retain the \$435 million goodwill "equity" in NorthWestern's post-acquisition capital structure.^{10/}

BBIL further attempts to cloud the picture by suggesting that what is shown in its acquisition model is only an evaluation exercise and not a real plan (*see, e.g.*, Exh. JA-7 at

^{10/} As it affects NorthWestern's future fulfillment of its public service obligations, the proposed acquisition creates a specific issue, in addition to the inappropriateness of including such adjustments in rates, with respect to the \$435 million in goodwill presently on NorthWestern's books. Absent the distribution practices pursued by BBIL, NorthWestern's ongoing enhancement of the equity portion of its capital structure would, over time, render NorthWestern less susceptible -- as a stand alone entity -- to risks arising from impairment of that good will. For this reason, among others, MCC believes that the Commission should adopt explicit conditioning language (proposed by the MCC as part of its proposed Condition No. 1) requiring the exclusion of goodwill currently on NorthWestern's books from rate base, operating expenses and capital structure.

3:4-21 (Sellar)). But this argument is plainly misleading. Not only were the financial forecasts shown in the BBIL Acquisition Model (and the additional sensitivity case that BBIL calls “the ‘Wilson’ model”) precisely the financial forecasts that BBI’s Board considered in making its offer to acquire NorthWestern, they were also the forecasts provided by BBI to Australian securities rating agencies in conjunction with securing investment ratings to fund this acquisition (Mar. 16 Tr. at 169-173; Exh. MCC-9, MCC-10 (confidential materials)). These forecasts were, therefore, not an abstract exercise but very serious representations that BBI management presented to its Board and to potential investors. Indeed, the acquisition model appears to be the foundation for investor expectations about the financial results that BBIL was seeking in the NorthWestern acquisition. As BBIL’s witness Garland testified (Mar.14 Tr. at 188:4-189:20):

Q. When you, as a general matter, provided pro formas to Moody’s, Mr. Garland, is it considered important that they be accurate?

A. They’re always important to us that they’re accurate, and what we represent to the rating agencies we believe is accurate representation of what we’re telling them at that moment.

...

Q. In general terms, then, could you define for me the purpose of providing a *pro forma* for ratings assessment?

A. To give them a reasonable estimate of the capability of Northwestern and the BBI entities, in this case to pay its debt.

...

Q. ... let’s take it as a hypothetical all right ... if BBI did provide the acquisition model to Moody’s in connection with the assessment of this acquisition, it would have been the company’s best effort in a 40 year forecast of earnings?

A. Yeah. It was our judgment at that moment of what we thought was a reasonable case on an aggregate analysis.

No doubt because the forecasted Northwestern dividend payouts have been the basis of the expectations of BBIL's Board and its investors, BBIL has been adamant in its resistance to any limitations on NorthWestern dividend payouts. The essential reason for limiting dividend payouts is to permit the attainment and preservation of a reasonable utility equity ratio which is not possible if more than 100 percent of earnings are paid out. A payout of more than 100 percent of earnings necessarily results in negative retained earnings and, consequently, the dissipation of the improved but still-anemic real equity capitalization that NorthWestern has been rebuilding since its emergence from Chapter 11 protection in November 2004.

BBIL now attempts to finesse this fundamental issue by suggesting in its Brief that it would be willing to accept a condition requiring a 40 percent "stand alone revision" of the "SEC-based" capitalization test presently used in Order 6505e as one determinant of the size of NorthWestern's Limited Investment Basket for non-utility investments (App. Op. Brief at 28-29).^{11/} While BBI has not provided sufficient detail to permit a full understanding of this

^{11/} This new post-hearing proposal apparently stems from witness Garland's response to a question from Commissioner Mood (Mar. 15 Tr. at 46:11-47:4 (Garland)):

Q. Why would not this Commission feel that it's, in the approval of the sale, feel that it's a reasonable thing to expect that the core business, NorthWestern's utility business to the State of Montana, be protected from any kind of threat that would destroy its financial integrity?

. . . .

A. I think that we would be willing to consider some type of condition on debt/equity that -- that that was the only condition. We would have to look at it in its totality. But I don't think it's unreasonable for you to look at those kind of -- that issue.

See also Mar. 14 Tr. at 134:2-6 (Hanson):

Our view is that Dr. Wilson proposes one way to do that. We think there are other ways of building equity and ensuring this Commission that we remain on the track of creating the stability, and we are certainly prepared to do that.

new post-hearing proposal, it is clear from what is said that the proposal is far from what is needed and very likely meaningless. First, while at one point BBI states that *any* acquisition premium would be excluded from equity (App. Op. Br. at 29 n. 4 (first sentence)), it later effectively rescinds this commitment by defining “acquisition premium” to mean “only the change in NorthWestern’s goodwill resulting solely from the BBI acquisition” (*id.* (last sentence)). In other words, the \$435 million of existing goodwill booked as a result of the \$375 million acquisition premium paid to acquire Montana Power (TouchAmerica) and the \$60 million reorganization intangible recognized on emergence from bankruptcy would be included in this equity test. Second, by specifying SEC accounting rather than regulatory accounting (Uniform System of Accounts) BBIL is apparently attempting to include another \$90 million of acquisition-related transaction costs (including a \$50 million deal consummation fee to be paid by BBIL to Babcock & Brown and \$30 million paid by NorthWestern to Credit Suisse) in the equity component of the capital structure.^{12/} While a

^{12/} BBIL’s inclusion of these acquisition costs in the equity component of NorthWestern’s capital structure was revealed for the first time at the hearing on March 16:

- Q. Let me just probe this a little bit more, Mr. Sellar. On line 92 of the balance sheet... I get the 114,435,000 that are carried on the balance sheet in your model as an asset, being deferred financing fees?
- A. I agree, subject to check.
- Q. What is the amount of the origination fee that’s being paid to Babcock & Brown for this transaction?
- A. The facilitation fee?
- Q. Facilitation fee, I’m sorry.
- A. I believe it’s in the order of 50 million.
- Q. Now, because that’s booked, that deferred financing fee line is booked in the balance sheet and the model as an asset, it carries through to equity, does it not, the way the model operates?
- A. I would assume so, yes.

40 percent equity ratio may be an acceptable minimum value, to be a meaningful solvency test it must be calculated straightforwardly, reflecting utility equity capital as reported in the utility company's FERC Form 1 Report (and in the Company's Annual Report to the MPSC) less any goodwill (and unamortized acquisition costs) recorded as assets in that same report. That, quite apparently, is not at all what BBI has in mind in proposing this vague new condition.

By paying out NorthWestern's equity while retaining rates that reflect a much thicker equity ratio (whether "hypothetical" or as reported for SEC purposes without deducting "goodwill") the acquisition premium and acquisition costs will be recovered from ratepayers.

**IV. AT A MINIMUM, THE COMMISSION MUST
CONDITION APPROVAL OF THE PROPOSED
ACQUISITION ON ACCEPTANCE OF THE
MITIGATION MEASURES PROPOSED BY THE MCC**

The Commission is empowered by MCA §§ 69-3-102 and 69-3-201 simply to disapprove the proposed acquisition in the exercise of its "full power of supervision, regulation, and control of such public utilities" (MCA § 69-3-102) because, as MCC has demonstrated at length in this Brief, the acquisition as proposed by the Applicants poses a threat to NorthWestern's ability to provide adequate service and facilities at rates that are

Q. And if that were removed, the equity would be that much less [sic], would it not?

A. It would be less.

Mr. Sellar later confirmed that in addition to the \$50 million fee to Babcock and Brown, there was an additional fee of \$30 million to Credit Suisse and consulting and legal fees amounting \$8 million more of transaction costs reflected in the equity component of NorthWestern's post-acquisition balance sheet. (Mar. 16 Tr. at 200-202 and 243 (Sellar)).

reasonable and just. The Commission need not exercise its power to foreclose the acquisition, however. The MCC believes that its proposed conditions are sufficient to mitigate the threat posed by the acquisition as proposed by the Applicants, and the Commission could choose instead to require acceptance of those conditions as a predicate to consummation of the acquisition. If the Applicants reject these essential conditions, then, of course, their proposed acquisition is not in the public interest.

In evaluating whether to condition the proposed acquisition or simply prohibit it, the Commission should not be swayed by the mere professions of good intentions which animate the Applicants' Opening Brief (App. Op. Br. at 8-18). The recent experiences of this Commission with utility acquisitions demonstrates both concretely and vividly that expressions of good intention by parties to a proposed acquisition are no substitute for effective and enforceable regulatory controls designed to protect the interests of consumers in ongoing availability of adequate service and facilities at rates that are reasonable and just. *See* Mar. 14 Tr. at 55:16-62:15 (Hanson) and Exh. MCC-2 in its entirety. Examination at hearing demonstrated that there is, in fact, very little beyond the protestations of good intention in the way of concrete, substantive, enforceable commitment that would protect consumer interests in the fulfillment of NorthWestern's public service obligations post-acquisition (Mar. 14 Tr. at 108-120 (Hanson)).

MCC reviews in this section of its brief the considerations that compel Commission adoption of those of its proposed conditions that the Applicants have opposed, in whole or in part. Referring to the MCC-proposed conditions identified at pages 3-5 of this Brief, MCC understands the Applicants to dispute the necessity or appropriateness (in whole or in part) of

MCC's proposed Conditions 1, 2, 3, 5.b. and 6. Notwithstanding the Applicants' objections, these conditions should be adopted in full as prerequisites for any Commission authorization of the proposed acquisition.

A. Modifications to Ring Fencing Requirements (MCC Conditions No. 3 and 5.b.)

MCC believes that the critical challenge that the proposed acquisition presents to the Commission is how best to protect Montana consumers' right to adequate utility service and facilities at rates that are reasonable and just. Recognizing the criticality of the issue, the Applicants belatedly offer a revised version of the equity capitalization test presently embedded in the Consent Order entered by the Commission in the Northwestern Financial Investigation (D2003.8.109, Order No. 6505e) as a substitute for a condition directly constraining NorthWestern's ability to make distributions exceeding net earnings (App. Op. Br. at 34-38). MCC reviews in this section (1) the necessity and appropriateness of direct regulation of dividending practices in the circumstances of this case, (2) the inadequacies of the Applicants' belatedly proposed equity capitalization test, and (3) how an effective equity capitalization test might be developed and applied.

1. Proposed Conditions

MCC proposes two conditions that are explicit enhancements to existing ring fencing conditions adopted in Order No. 6505e in D2003.8.109, the NorthWestern *Financial Investigation* proceeding. The two conditions are suitable for incorporation in Order No. 6505e, or they could be made stand alone conditions to authorization of the acquisition. The proposed language of the conditions is as follows:

Condition No. 3

Unless specifically and affirmatively authorized by the Commission, there shall be no distribution, directly or indirectly, from NorthWestern to its owners, affiliates or to stockholders of affiliates, of any amount exceeding 100 percent of NorthWestern's net earnings in any year.

Condition No. 5.b.

The existing structural and financial measures, intercorporate and affiliate transactions requirements, reporting and disclosure requirements, and infrastructure audit compliance requirements from Order No. 6505e (the Financial Investigation Consent Order), should be maintained in place, subject to modification of the following provisions:

* * * *

b. Ordering Paragraph C.3.a should be modified to reflect a basis for determining consolidated book equity and consolidated total capitalization that is meaningful as a regulatory tool in the context of the post-acquisition corporate structure, and the financial reporting requirements to which that corporate structure will be subject. Specifically, dividends should be limited to no more than 75 percent of net earnings at any time when equity (defined as assets less all goodwill, less unamortized acquisition expenses less all liabilities) is less than 40 percent of the sum of equity and all debt, and to no more than 90 percent of net earnings at any time when equity is between 40 percent and 45 percent of the sum of equity and all debt,

using all values as reported in the utility's audited FERC Form No. 1 Annual Report.

2. Explanation of Proposed Conditions 3 and 5.b.

When current ring fencing requirements were implemented they were not designed to deal with the currently proposed corporate structure in which NorthWestern would become a wholly-owned dividend paying subsidiary of BBIL. Most notably, there was then no apparent need to protect the utility against extraction of excessive dividends by a corporate parent having complete control of the utility's board of directors. Under BBI ownership and control, protection will now be needed not only against the draining of utility finances by subsidiaries and horizontal affiliates, but also against equity extractions from above by NorthWestern's new corporate parent. This need was candidly recognized by BBI witness Garland (Mar. 15 Tr. at 40-41):

Q. My understanding of ring fencing is that it protects the assets of the regulated utility from being encumbered by other subsidiaries of a holding company or a master company. In other words, they cannot obligate the assets of the utility with loans to other entities outside of the utility. Is that generally correct?

A. Actually it goes quite a ways beyond that, I believe. The intent of ring fencing is to, if you will, isolate that operating business upwards and downwards, which means not only from, say, a parallel subsidiary like we described, the Cross Sound Cable, coming across and interfering with NorthWestern or having liens against NorthWestern's operations. It's also if it's coming down the chain, it helps insulate any access of any of the parties coming down the chain to get to the ring-fenced entity.

So it's kind of, if you will, a shell around that operating entity going in and out. We don't allow it to go out because you don't - - it kind of violates the shell; that it it's going over and trying to guarantee Cross Sound Cable, for example, that would violate our interpretation of what ring fencing is about. Ring fencing is really meant to isolate that

regulated business so that it's not interfered by anything else, going either direction.

To accomplish this essential new need (which is all the more evident in view of the dividend payout plan in BBIL's acquisition model) MCC has proposed that, as Condition No. 3 to the proposed acquisition, NorthWestern must agree to obtain Commission approval prior to paying a dividend that exceeds earnings. While BBIL opposes this condition, MCC submits that it is the safest, least complicated and most straightforward way to protect NorthWestern's capital structure and thereby preserve its ability, post-acquisition, to provide adequate facilities and service at rates that are reasonable and just. The following considerations support the exercise of direct and explicit Commission control over distributions in excess of net earnings.

- First, it is beyond dispute that dividends in excess of earnings result in negative retained earnings and equity erosion.
- Second, dividends in excess of earnings are rare exceptions and not standard policy throughout the electric and gas utility industries.
- Third, exceptions to this rule (as may be warranted in a year of unusual and unexpectedly low earnings or as occurred for NorthWestern in 2006 due to an unforeseen accounting adjustment after the end of the year) can be easily accommodated as warranted.
- Fourth, this approach avoids the accounting gamesmanship, complication and confusion that will be far more likely with an alternative capital structure condition as BBI now proposes (App. Op. Br. at 29).

Clearly, in order to afford any meaningful financial protection at all, ring fencing restrictions must curb excessive extractions of utility capital by a controlling parent. Restricting the issuance of utility debt to fund a parent's non-utility enterprises, while allowing unfettered extractions of utility equity capital for the same purpose, simply makes no sense. Such a foreseeably futile course of action would be analogous to building the walls of a house to protect the inhabitants from the elements, and then neglecting to build a roof.

Condition 5.b. would, in addition to the restriction on distributions set forth in Condition 3, provide for the use of a capitalization test or capital structure rule as an additional ring fencing tool to protect utility consumers from dissipation of retained earnings. MCC believes that, if a capitalization test were the only control on excessive distributions of earnings, it would be an inferior choice for protecting NorthWestern's ability to fulfill its public service obligations. However, as a supplemental ring fencing against improvident distribution of retained earnings to a parent entity through the implementation of a capital structure rule, MCC believes that a condition fashioned in the simplest and clearest terms would be a useful and beneficial adjunct to the Condition 3 restriction on dividending in excess of earnings. Specifically, MCC would propose a condition that limits dividends to no more than 75 percent of net earnings at any time when equity (defined as assets less all goodwill, less unamortized acquisition expenses less all liabilities) is less than 40 percent of the sum of equity and all debt, and to no more than 90 percent of net earnings at any time when equity is between 40 percent and 45 percent of the sum of equity and all debt, using all values as reported in the utility's audited FERC Form No. 1 Annual Report.^{13/} The

^{13/} This requirement to protect NorthWestern's equity capital is urgently needed now as a precondition to any merger approval. It is obvious that BBIL's plans are to the contrary. It is

alternative proposed at page 29 of the Joint Applicant's initial brief would provide little, if any, protection as it would include at least \$435 million of goodwill in equity (plus at least \$88 million of unamortized transaction costs) and thus permit BBI to pay out NorthWestern's real equity down to a level that is less than 10 percent of the Company's total debt plus equity capitalization.

B. Exclusion of Acquisition Premiums, Deferred "Facilitation Fees" and Acquisition Costs From Retail Rate Base, Operating Expenses and Cost of Capital (MCC Condition Nos. 1 and 2)

The MCC also proposes two conditions that will ensure that acquisition premiums and other forms of "goodwill" that do not represent the value of assets used in the fulfillment of NorthWestern's public service obligations will be excluded from retail rates. The Applicants have offered the Commission assurances that there will be no attempt to include in NorthWestern's rates the approximately \$700 million premium over book value that BBIL

also obvious that allowing utility rates that reflect returns on hypothetical equity investment in utility plant, when real equity has actually been dividdened out, would effectively require NorthWestern's ratepayers to fund BBI's acquisition premium. Waiting until these things occur and trying to deal with them then is not a rational alternative. As BBI witness Boulton acknowledged, while the Commission has the ability to confront, curtail and control this threat now, if it fails to do so that ability is not likely to remain in the future (Mar. 16 Tr. at 154-155):

Q. As I understand it one of the concerns at least that I've heard voiced is that once the distribution and the money moves up and out of NorthWestern it's kind of beyond any control that we would have.

...

A. In terms of available cash flow we'll be looking at that model. That's the - - we've been quite open. That's the methodology that we apply to all of our businesses,

...

Q. Would you agree that once it leaves NorthWestern it's beyond our jurisdiction to reach any of those funds?

A. That comment can be made. ...technically, I think your answer is right.

proposes to pay to acquire NorthWestern. While the Applicants have explained this offer in terms of excluding goodwill from rate base, their intentions regarding capital structure are not assuring. The MCC proposes the following two conditions to ensure that ratepayers are not burdened with the costs of a transfer of ownership that does not produce any change in service value of the affected assets. As the Federal Energy Regulatory Commission has observed, “A change in ownership alone does not increase the service value of a facility and so provides no basis for increasing the associated rate base and depreciation.” *Locust Ridge Gas Co.*, 29 FERC ¶ 61,052 at p. 61,114 (1984).

1. Proposed Conditions

Condition No. 1

There should be no recovery in retail rates, directly or indirectly, in any manner or by any means, any portion of any premium over book value paid or proposed to be paid for the acquisition of control of the Montana public utility assets currently owned by NorthWestern, unless such recovery is expressly and affirmatively authorized by order of the Commission upon application demonstrating specific and concrete benefits to Montana consumers resulting from the payment of such premium. The exclusion established by this condition shall apply equally to (a) the approximately \$700 million premium over book value proposed to be paid by BBIL to acquire NorthWestern, (b) the \$375 million premium over book value previously paid by NorthWestern to acquire the assets of Montana Power Company, and (c) the \$60 million “reorganization intangible” booked by NorthWestern upon its emergence from Chapter 11 protection in November 2004. The exclusion established by this condition shall apply equally to treating any of the premiums over book value

described in the preceding sentence as (i) part of rate base, (ii) part of operating expense and (iii) part of NorthWestern's equity capitalization for purposes of determining retail rates.

Condition No. 2

The transaction and transition costs incurred by BBI and NorthWestern shall be absorbed exclusively by the shareholders of each of the parties to the acquisition. None of the \$88 million in "facilitation fees" and transaction costs associated with this transaction shall be treated as "deferred financing costs" for purposes of retail rate recovery or as part of NorthWestern's equity capitalization for purposes of determining retail rates.

2. Explanation of Conditions

As the Commission is well aware, utility revenue requirements and rates are determined as the sum of the utility company's operating expenses plus the product obtained by multiplying rate base times cost of capital. Thus, acquisition premiums and goodwill end up in rates if they are included in any of these three components – expenses, rate base or capital. While stating that goodwill will not be included in rate base, BBIL apparently intends to include substantial goodwill in the equity component of its capital structure and to charge goodwill to utility ratepayers.^{14/} While it may be argued that capital structure for

^{14/} While Mr. Hanson stated that the Applicants would be agreeable to a condition excluding all goodwill (including the \$435 million in goodwill that is already on NorthWestern's books) in determining NorthWestern's weighted average cost of capital for ratemaking purposes (Mar.15 Tr. At 234:6 – 235:5), he appeared to leave open using a "hypothetical" capital structure with more than book equity net of goodwill as the common equity component. Issues relating to the potential use of a "hypothetical" capital structure are appropriately deferred to consideration of a detailed proposal evaluating the cost impacts to consumers of using (or not using) such a device to establish rates. In the abstract, however, it bears emphasis that ratepayers would be forced to pay for an acquisition premium whether it is

ratemaking is a rate case issue that need not be resolved here, capital structure manipulation is so fundamental to BBIL's acquisition plan and so critical to Northwestern's ongoing financial solvency that conditions governing capital structure for financial operating purposes are essential here even if related ratemaking resolutions are deferred.

BBIL's capital structure intentions were clearly presented in its Acquisition Model, where the entire acquisition premium in this case plus preexisting goodwill were booked as assets and carried over to the equity capital balance. Based on the large acquisition premium that was thus added to equity, BBIL attempted to rationalize its plan for huge dividend payouts as being necessary to bring Northwestern's equity ratio back down to an "acceptable" level for a utility (i.e., 50 percent). These payouts included not only dividends far in excess of earnings for the next 17 years, but also new borrowings to fund additional \$90 million dividend surges in 2008 and 2010. In fact, as Dr. Wilson's testimony demonstrated, these projected payouts actually reduced Northwestern's equity (net of acquisition premium) to unacceptably low levels (i.e., 16.9 percent with new transmission investments and less than 4 percent without them).

To preclude this imminent financial solvency threat from occurring, MCC recommends a condition limiting Northwestern's annual dividend payout to no more than 100 percent of earnings without Commission approval. Alternatively, but with greater risk of attempts to finesse rather than address the relevant problem, an ongoing capital structure limitation that requires a minimum "real" equity ratio of 40 percent could address the same

included directly in capitalization or whether it is removed and a "hypothetical" increment of equity is put in its place to establish rates.

problem – but only if all goodwill (and deferred acquisition costs) are excluded from the equity computation.^{15/}

The Applicants have argued that there is no nexus between restricting Northwestern's dividend payout to 100 percent of earnings and maintaining the utility Company's equity, financial health and adequate service at reasonable cost (App. Op. Br. at 24). They are wrong. The nexus between utility company dividend payout ratios and maintaining utility equity, financial health, adequate service and reasonable rates is well-known and nearly as venerable and longstanding as public utility regulation itself. It is this: (1) excessive payout ratios drain equity; (2) inadequate equity means no safety net against business fluctuations and asset revaluations and, therefore, only limited high cost access to capital; (3) impaired financial safety, limited capital access and reduced business flexibility, in turn, threaten the adequacy and raise the cost of utility service. For these reasons, and especially in the light of BBIL's financial plan for Northwestern, a condition effectively limiting equity payout and maintaining adequate real equity in Northwestern's utility capital structure is the most urgently needed condition for acquisition approval in this case.

^{15/} One such finesse is evident, for example, in the proposed capital structure condition suggested in the Applicant's Opening Brief at page 29. Applicants first appear to propose a 40 percent equity condition, but then eviscerate it by providing that the existing \$435 million of goodwill would remain treated as part of the equity component of NorthWestern's capital structure – thus allowing BBIL to extract this amount in excessive dividends, drawing the real equity balance down to less than 10 percent of total capitalization. In addition to defeating the purpose of the 40 percent condition, this approach by the Applicants is entirely inconsistent with Mr. Hanson's acceptance at trial (see pages 17-18 above) that equity capital for regulatory purposes should exclude the Company's previously accumulated \$435 million of goodwill.

C. Triennial Rate Information Filings

The incorporation of NorthWestern’s Montana utility operations into the multi-level and multi-function holding company structure that BBIL’s pre-acquisition modeling contemplates has the potential to complicate the task of ensuring that NorthWestern’s rates remain reasonable and just. The MCC recommends the Commission schedule regular reviews of NorthWestern’s rates over the first ten years following the acquisition in order to ensure adequate opportunities to monitor NorthWestern’s capitalization, capital and operational expenditures and the numerous other issues customarily reviewed on the basis of the submittals described in ARM 38.106 through 38.5.195.

1. Recommended Condition

Condition No. 6.

NorthWestern shall submit rate informational filings every three years, commencing on the first anniversary of consummation of its proposed acquisition by BBIL, conforming to the requirements of Ordering Paragraph B.1 of Order 6505e (including responding to discovery)^{16/} for rate review for the initial ten years following the acquisition, to ensure against excessive rates.

^{16/} In relevant part, Ordering Paragraph B.1. of Order 6505e requires NorthWestern to “file complete documents complying with the minimum electric and gas rate case filing standards provided in ARM 38.5.106 through 38.5.195, including any additional documentation required for interim electric and gas rate adjustments as provided in ARM 38.5.501 through 38.5.507, whether or not an interim adjustment is or has been sought. Following such filing, NorthWestern shall respond to all reasonable discovery and data requests: (i) in accordance with the requirements of ARM 38.2.3301 through 38.2.3305 and the Montana Rules of Civil Procedure as thereby made applicable; and (ii) in accordance with any procedural schedule established by the Commission in connection with such filing.”

2. Explanation of Proposed Condition

BBIL's acquisition model demonstrates that the financial condition of NorthWestern as an operating utility can deteriorate, or effective rates of return increase dramatically, with relative quickness given the manner in which BBIL distributes both earnings and equity of operating companies to its holding companies. Enhanced scrutiny of NorthWestern's rates for the first ten years following the acquisition should enable the Commission to detect and deal with any unforeseen adverse developments in NorthWestern's rates.

The focus of disagreement between the MCC and the Applicants as to this proposed condition is the number of reviews that ought to be available to the Commission during the first ten years following the acquisition. The Applicants insist that two such rate informational filings are all that should be required; the MCC believes that the Commission should be assured of the opportunity to require a third rate review should the Commission find such review necessary. The magnitude of the adverse impacts that an unconditioned acquisition would impose on Montana's utility consumers, as outlined throughout this Brief and in the MCC's evidence in this case, clearly warrant erring on the side of providing additional protection against rates that are unreasonable or unjust. Accordingly, the Commission should order the additional rate information filing.

V. CONCLUSION

For the reasons set forth in this Brief, the Commission cannot authorize the acquisition as proposed by the Applicants. The only basis on which the acquisition should be permitted to proceed is the Applicants' acceptance of all seven conditions recommended by the MCC. Accordingly, the Commission should make and enter an order that would allow

the acquisition to proceed if, and only if, the Applicants accept all seven conditions proposed by the MCC.

Respectfully submitted,

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